

Review of literature on sustainable investments

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7th February 2005

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1 Overview on Sustainable Investment

1.1 Definitions

In the "Call for pre-proposals for a large-scale research programme" MISTRA defines Sustainable Investment as:

...investments which aspire to make an explicit contribution to Sustainable Development, by means of different techniques, methodologies and supporting activities (e.g. engagement with companies).

Sustainable Development has been defined by the World Commission on Environment and Development as: "development that meets the needs of the present without compromising the ability of future generations to meet their own needs" (World Commission, 1987).

The terminology in the field of sustainable investments has not yet been settled and, in fact, the term "Sustainable Investment" (SI) is used infrequently. The terms used are instead: socially responsible investment (SRI); responsible investment; social investment; ethical investment; or green investment. Different terms are used interchangeably by different authors to describe the same phenomena, and the same terms are sometimes used to describe different phenomena. MISTRA's definition of SI is broader than either of the above-mentioned terms, taking "green" as well as social aspects of investments into account, and emphasizing investing in the long-term.

1.2 The Argument for Sustainable Investments

It has become increasingly evident that current practices cannot be permitted to continue without substantive change, both with regard to the uneven rates of development between different parts of the world, and to the burgeoning world population's ever increasing demands on finite natural resources (LeVeness and Primeaux (2004)). Voices are raised in favor of putting sustainable development at the top of the agenda due to deep world-wide poverty, increasing population growth, and limited resources within an already threatened ecosphere (DesJardins (1998)).

That the future change towards sustainable development must begin with corporations taking their social, environmental, and ethical responsibility has been argued by many (e.g., Gladwin et al. (1995); Friedman and Miles (2001)). In order for corporations to change towards taking their responsibility with regards to the triple bottom line (referring to economic, social, and environmental concerns), some investors have tried to exert pressure by the

way they invest or not invest in those companies. Up until now, these investments have mainly been made by a segment of particularly environmentally and ethically concerned *individual* investors. As a consequence, investments in SRI-related mutual funds so far amount to a rather small share of total funds under management. According to Haigh and Hazelton (2004) SRI retail mutual funds account for 0.40 percent of total funds under management in Europe, and in Australia and U.S. it accounts for 0.20 and 0.30 percent, respectively. The main body of research suggests that for SRI to move from a niche-market to mainstream, institutional investors should implement an overall SI policy encompassing all their assets under management (Perks et al. (1992)).

The way a company can be affected on its social, ethical, and environmental conduct, could be displayed as in figure 1.1.

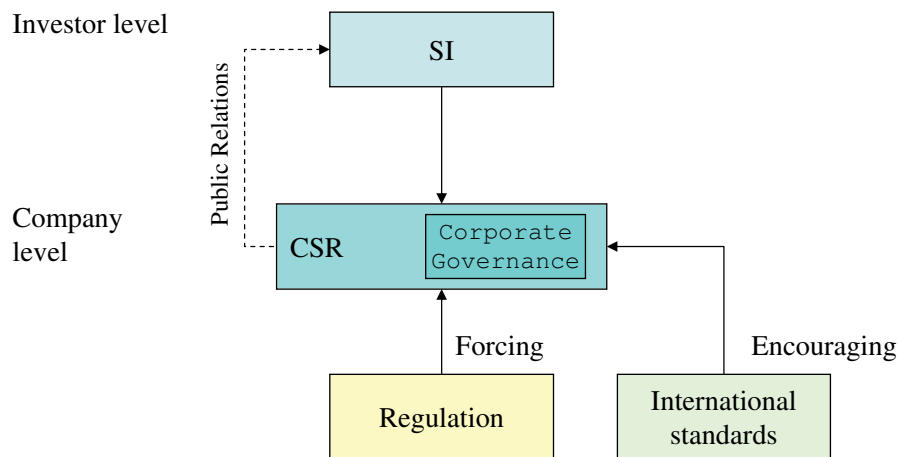


Figure 1.1: **Factors affecting corporate social responsibility.** Abbreviations: SI = Sustainable Investments; CSR = Corporate Social Responsibility.

The European Union defines Corporate Social Responsibility (CSR) as¹:

...a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis.

Corporate governance has to do with the way in which decisions over claims are taken in a company (powers of managers and shareholder) and with the corresponding issue of accountability and transparency with respect to decisions taken. These issues are determined by company laws and

¹As referenced in Hockerts and Moir (2004)

securities laws, by accounting rules and practices, and by history and politics. Companies have to abide certain regulations put up by the government in the countries in which they operate. Also, international organizations with SI-agendas present standards that they want the corporations to meet. Examples of such standards are: AccountAbility (AA1000); CERES Principles; Social Accountability (SA8000); Global Reporting Initiative (GRI); and Forest Stewardship Council Standard. Below are descriptions of each of these standards, as presented on respective organization's webpage.

AccountAbility (AA1000) was launched in 1999 and is a framework designed to improve accountability and performance by learning through stakeholder engagement. It was developed to address the need for organisations to integrate their stakeholder engagement processes into daily activities. The Framework helps users to establish a systematic stakeholder engagement process that generates the indicators, targets, and reporting systems needed to ensure its effectiveness in overall organizational performance. The building blocks of the process framework are planning, accounting and auditing and reporting. It does not prescribe what should be reported on but rather the 'how'. In this way it is designed to complement the GRI Reporting Guidelines.

By endorsing the seven CERES Principles, companies not only formalize their dedication to environmental awareness and accountability, but also actively commit to an ongoing process of continuous improvement, dialogue and comprehensive, systematic public reporting. Endorsing companies have access to the diverse array of experts in the CERES network, from investors to policy analysts, energy experts, scientists, and others.

Social Accountability (SA8000) considers key issues such as child labor, compensation, discrimination, forced labor, working hours, health and safety, freedom of association, and disciplinary practices. It includes also a set of standards on the Management system necessary for the successful implementation of SA8000.

The Global Reporting Initiative (GRI) is a multi-stakeholder process and independent institution whose mission is to develop and disseminate globally applicable Sustainability Reporting Guidelines. These Guidelines are for voluntary use by organisations for reporting on the economic, environmental, and social dimensions of their activities, products, and services. The GRI incorporates the active participation of representatives from business, accountancy, investment, environmental, human rights, research and labour

organisations from around the world. Started in 1997, GRI became independent in 2002, and is an official collaborating centre of the United Nations Environment Programme (UNEP) and works in cooperation with UN Secretary-General Kofi Annan's Global Compact.

The Forest Stewardship Council has ten Principles of Forest Stewardship. These Principles and associated Criteria form the basis for all Forest Stewardship Council (FSC) forest management standards. FSC is an independent, not for profit, non-government organisation based in Bonn, Germany, that provides standard setting, trademark assurance and accreditation services for companies and organisations interested in responsible forestry. FSC's mission is to promote environmentally appropriate, socially beneficial and economically viable management of the world's forests.

1.3 The Processes of Sustainable Investing

There are different methods that investors use in order to promote sustainable development. One approach is based on *avoidance*, or *negative screening*, where companies that do not meet certain criteria are excluded from the fund manager's investment universe. The criteria may rule out companies involved in a certain industry, or companies that exceed a maximum percentage of their turnover in a problem area. A second approach is based on *positive screening*, or *best-in-class*, where only the best companies in a certain industry are included in the fund manager's investment universe. A third approach is based on types of *shareholder activism*, or *engagement*, where investors through a dialogue with corporate executives seek to affect companies' social, environmental, and ethical practices (Sparkes and Cowton (2004)).

Figure 1.2 displays the distribution over techniques used by a selection of specialist SRI funds, surveyed in CSR Europe (2003). The figure shows that several techniques are normally combined. Negative screening only is used by three of the funds, while most of the funds combine negative screening with positive screening and/or engagement.

1.4 Financial Performance of SRI Mutual Funds

Several studies have investigated and analyzed the financial performance of SRI (or ethical) mutual funds compared to conventional mutual funds. Although some authors report equivalent (or in some instances even higher) returns for SRI mutual funds to conventional mutual funds, the results are inconclusive.

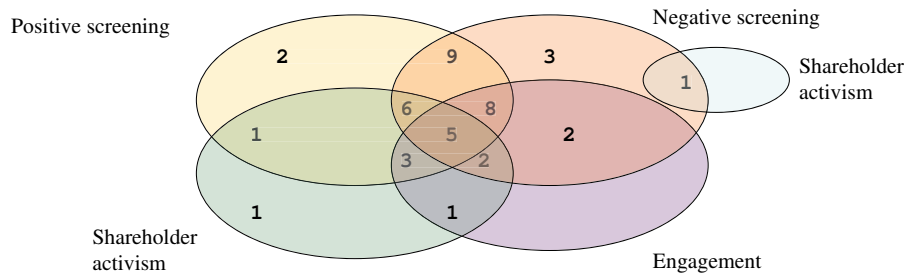


Figure 1.2: **Techniques used in socially responsible investing.** The question: "What technique do you use in your SRI approach?", was asked to fund managers and analysts. *Source:* CSR Europe (2003)

In a study on 103 German, U.K., and U.S. ethical mutual funds during the period 1990-2001, Bauer et al. (2005) found little evidence of significant differences in risk-adjusted returns between ethical and conventional funds after controlling for investment style. Introducing time-varying betas leads to underperformance of domestic U.S. funds and a significant outperformance of U.K. ethical funds to their conventional peers. They document a "learning effect". This means that after a period of strong underperformance, older ethical funds are catching up, while younger funds underperform both the index and conventional peers. However, for the period 1995-2003 Bauer et al. (2004) found that there is a SRI premium for the U.S.; and by neutralizing unintended style and industry-group bets, the risk-return trade-off of SRI strategies was enhanced even further. In another report, it is showed that eighty percent of the largest socially responsible U.S. mutual funds tracked by the Social Investment Forum (48 mutual funds) received top marks for financial performance in the ratings of: Morningstar; Lipper Analytical Services; and Wiesenberger (Schueth (2003)).

Other studies have investigated the performance of ethical indices in comparison to the performance of conventional market indices. In Statman (2000) it is showed that the Domini Social Index² did better than the S&P 500 Index over the 1990-98 period. Also, socially responsible mutual funds did better than conventional mutual funds during the same period. None of the above differences were, however, statistically significant. Both socially responsible and conventional mutual funds trailed the S&P 500 Index. Venix et al. (2004) compared sustainability indices to non-sustainability indices. The sustainability indices outperformed their traditional counterparts, but differences in return were not statistically significant. In the same fashion,

²The Domini Social Index is an index of stocks of socially responsible companies that was initiated in May 1990 by Kinder, Lydenberg, Domini & Company.

Guerard (1997a) compared the returns of an unscreened equity universe of 1,200 stocks to the returns of a socially screened universe of approximately 950 stocks during the 1987-1996 period, and found no statistical difference in average return. The social screens used were those of Kinder, Lydenberg, and Domini & Company.

In Geczy et al. (2003) SRI fund portfolios are compared to those constructed from a broader fund universe. It is concluded that imposing a SRI constraint³ on investors seeking the highest Sharpe ratio imposes a cost. More importantly, it is also found that to an investor who believes strongly in the CAPM and rules out managerial skill, i.e. a market-index investor, the cost of the SRI constraint is typically just a few basis points per month, measured in certainly-equivalent loss. To an investor who still disallows skill but instead believes to some degree in pricing models that associate higher returns with exposures to size, value, and momentum factors, the SRI constraint is much costlier, typically by at least 30 basis points per month. Furthermore, the SRI constraint imposes large costs on investors whose beliefs allow a substantial amount of fund-manager skill, i.e., investors who rely heavily on individual funds' track records to predict future performance.

Some authors point out that when evaluating the performance of screened versus unscreened universes one has to correct for biases arising from tilts towards either large stocks, small stocks, value stocks or growth stocks (Vennix et al. (2004)). This bias may cause return differences compared to the original universe and to non-sustainable indices. Guerard (1997b) developed a stock-selection algorithm based on I/B/E/S (Institutional Brokers Estimate System) earnings forecasts, and applied this to an unscreened universe and then to a screened SRI universe. It was found that the returns earned by the socially screened stocks were higher.

In reviewing the literature comparing the financial performance of SRI mutual funds to their conventional counterparts, Sparkes (2002) draws three main conclusions. First, SRI exclusions make an insignificant difference to index returns over any reasonable time frame. Second, most U.K. SRI unit trusts and U.S. SRI mutual funds have historically made slightly lower returns than a peer group of comparable trusts, although this performance cost is probably acceptable to its investors. Third, academic research on SRI financial performance has been made on specialist retail funds whose performance data is widely available. Recently, however, some institutional investors have adopted socially responsible criteria. Data and research on these investments are not available, i.e., this is a prospect for future research.

³The SRI constraint is simply the constraint to the investor to only invest in socially responsible companies.

Even though the aspects of sustainable development are important to the corporate community and its stakeholders, the investment community remains largely unconvinced (Merme and Zedek (2004)). It will be important to establish a link between the financial, social and environmental performance of the company so that corporations' social, environmental, and ethical work receive a heavier weight by investors in the future. No such conclusive link has yet been established (Merme and Zedek (2004)), although some authors have found a positive linkage between corporate social performance and financial performance. Graves and Waddock (1997) constructed an index of CSP based on the eight corporate social performance attributes rated consistently across the entire Standard & Poors 500 by the firm Kinder, Lydenberg, Domini. As indicators of firm financial performance they used return on assets, return on equity, and return on sales. Corporate social performance was found to be positively associated both with prior financial performance and with future financial performance.

2 The Importance of Mainstreaming SI

Most researchers agree that sustainable investments have to become mainstream in order for corporations to change the way in which they operate. According to Dillenburger et al. (2003), the socially responsible investment industry is now slowly changing from a screening avoidance paradigm to a comprehensive paradigm that seeks to affect corporate behavior by other methods. In reviewing the sustainable investment literature, Sparkes and Cowton (2004) argue that the main body of research suggests that in order to achieve a more sustainable development, investors should seek to engage in the way companies do its business rather than just using avoidance criteria. To achieve desired social and environmental outcomes, SRI-retail funds should address issues at a systemic level - preferably by collective lobbying of corporations and, especially, governments (Haigh and Hazelton (2004)). However, more large institutional investors, such as pensions funds, also need to adopt SRI principles if companies are to be persuaded to change their operations (Haigh and Hazelton (2004)). Preliminary evidence suggests that an increased interest from mainstream fund managers in SRI modes of corporate assessment will create a greater legitimacy of CSR within the accounting orthodoxy (Friedman and Miles (2001)).

Haigh and Hazelton (2004) argue that socially responsible investing so far has been unsuccessful in affecting corporations towards behaving in a more sustainable manner. They mean that the validity of the "cost of capital" argument, i.e., that SRI investments affect corporate change by reducing the

cost of capital for "good" companies relative to "bad" ones, is dependent on whether the relative size of the SRI fund is large enough to create economic effects. Brammer et al. (2004) report that institutional investors primarily select through exclusion and thereby reject those firms which have the worst corporate social performance (CSP), a practice also used by most SRI retail funds (Schepers and Sethi (2003)). However, it is argued in Haigh and Hazelton (2004) that the constitution of a SRI fund may not be markedly different to that of a conventional mutual fund, since few companies fall prey for negative screens.

There is an ongoing discussion whether SI is already becoming a part of how mainstream institutional investors are making their decisions. Sparkes and Cowton (2004) argue that mainstreaming of SRI is already under way, which has also been supported by other authors. McCann et al. (2003) maintain that SRI no longer is restricted to ethical funds but currently is being increasingly adopted by the majority of pension funds and large institutional investors. In the U.K. this development has been encouraged by government legislation. Since 2000, all trustees of occupational and local government pension schemes are required to state their policy on SRI according to the Statement of the Investment Principle.⁴ Solomon et al. (2002) maintain that this has been a significant driver in the growth of SRI, which has encouraged many trustees to develop SRI policies.

On a question whether social and environmental characteristics will become a significant aspect of mainstream decisions in the next two years, 52% of the surveyed fund managers and analysts, and 47% of investor relations officers answered yes (CSR Europe (2003)). A report from Eurosif (Eurosif (2003)) states that the European institutional SRI is presently gaining momentum in being accepted by the financial sector. One of the drivers behind this development is that in several countries such as the UK, France and the Netherlands, employee representatives nowadays have been granted signifi-

⁴Under an amendment to the 1995 UK Pensions Act that came into force on July 3, 2000, the trustees of UK occupational and local government pension schemes have to state their policy on ethical investment in their Statement of Investment Principles (SIP). This includes:

- " the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments;
- and their policy (if any) directing the exercise of rights (including voting rights) attaching to investments".

This does not mean that trustees have to take account of social or environmental concerns within their investment strategies, but they are obliged to state whether or not they do so.

cant power in the management of pensions or employee savings plans. This has been a deciding factor in the move of these latter funds towards SRI. Simultaneously, the report concludes that no comprehensive study on the institutional sector yet exists.

3 Impediments to Mainstreaming SI

There are various impediments to a wider adoption of the SI thinking among institutional investors. Several possible barriers for SI to become a mainstream practice among institutional investors have been identified in the literature, although not much empirical work has been carried out; hence there is a need for future research in this area.

3.1 Short-termism

Short-term financial targets (such as bonuses based on quarterly performance) within the investment community are a significant constraint to the internalization of social and environmental factors into mainstream investment. Short-term strategies over time create and reinforce market conditions which they thrive, often actively undermining other strategies (Merme and Zedek (2004)). By studying the behavior of nine large American pension funds, O'Barr and Conley (1992) concluded that the quarterly financial evaluation and accountability leads to a language, and perhaps also a thinking, of the short term. Similarly, based on interviews with fund managers in the U.K., Guyatt (2004) concluded that short-termism within institutional investment organizations is a reflection of the shorter-term performance measurement and review cycle whereby quarterly review and annual bonus payments are conventional practices. Although the institution's objective might be long-term, in reality investors are pushed towards managing against shorter-term goals since that is the basis upon which trustees measure and assess their performance. In line with this, (Mills et al. (2001)) maintain that analysts are focused on maximizing returns on behalf of clients on a relatively short-term basis, generally three years, and this serves to undermine the consideration of environmental factors, which are seen as relevant only over a longer time-frame .

3.2 Herding

It has been documented that institutional investors' demand for a security this quarter is positively correlated with their demand for the security last

quarter (Sias (2004)). The fact that they follow each other into and out of the same securities implies that they herd. Guyatt (2004) argues that the implication of being pulled towards the shorter term is that it increases the risk that investors might get caught up in a 'herd mentality'. There tends to be a gravitation towards the defensible, since a decision based on more conventional criteria will be easier to defend than those that are unconventional or go against prevailing consensus opinion. Also, Guyatt (2004) found that investors of institutional assets consider it to be riskier to incorporate responsible investment into the core investment process because, they argue, it is not conventional and may not have a discernable impact on the share price over their investment horizon. In a similar vein, Badrinath et al. (1989) point out that herding may be encouraged by regulation. In the U.S., the behavior of institutional managers is subject to restrictions under both common law and the Employee Retirement Act of 1974 (ERISA). Under these laws, the managers, in their fiduciary capacity, are expected to behave in the manner of a prudent person. By introducing costs to managers in the event of poor economic performance and by making it easier to bring legal action against them, ERISA has implicitly discouraged managers from making investments which may be deemed imprudent. In the case of poor economic performance of the portfolio, a "safety-net" is provided to managers if they can demonstrate that their judgement of the soundness of a particular investment choice was shared by others (Badrinath et al. (1989)). Fiduciaries under this law have an incentive to protect themselves from liability by tilting their portfolios toward high-quality assets that are easy to defend in court (del Guercio (1996)).

3.3 Lack of Non-financial Information

Dillenburg et al. (2003) argue that social metrics that capture SRI management processes are still underdeveloped, and as a consequence, socially responsible investing analysis is not yet a mainstream component of investment analysis. However, they propose that once rating schemes measuring companies' social and environmental performance are well developed and coordinated, such schemes will have tremendous impact in influencing corporate behavior, since "what gets measured gets managed". The quality of information available to investors enabling them to relate social and environmental performance to financial performance is, at the moment, at best limited (Merme and Zedek (2004)). Crucial in addressing the issue of data quality are the costs of acquisition and analysis. Factoring in non-financial risks and opportunities is still costly, although increased availability of quality data from analysts such as the Sustainable Asset Management (creator

of the Dow Jones Sustainability Index) has enhanced access to, and reduced cost of investor friendly non-financial data (Merme and Zedek (2004)). In an Australian study by Fayers et al. (2000) it was argued that there is a modest shift towards environmental considerations among investment professionals and that some forms of environmental risk are being assessed. However, there are constraints to the inclusion of environmental performance, most of which relate to the nature and availability of reliable information. Companies will only provide environmental information which is favorable to their corporate image (Deegan and Rankin (1996)). Sparkes and Cowton (2004) point out that one problem with positive screening is that there is relatively little agreement on what positive issues should be taken into account, nor much data on which to assess them. As a consequence, negative screening tends to be the dominant investment strategy.

3.4 Insufficient Knowledge of Beneficiaries' Needs

Many trustees are not able to understand, assess and determine the longer-term needs of their members. The role of trustees has conventionally been interpreted in law and practice to mean that they may only use financial criteria in their investment decisions (Merme and Zedek (2004)). However, Lewis and Mackenzie (2000) showed that some individual investors are willing to accept a lower financial return for investments made according to ethical principles.

3.5 Organizational Shortcomings

There may be organizational impediments in the way SI investment decisions are being made and how they are implemented throughout various organizational levels. Cowton (1999) studied the development and implementation of ethical criteria in an ethical investment fund. He found that the criteria laid out by the funds Advisory Committee were not fully implemented by the fund manager, who was critical towards restrictions laid upon him. Although this study did only cover the ethical criteria implemented at one ethical fund, it highlights the discrepancy that may exist between the funds advisory committee's official ethical policy and the application of it by the fund manager. Guyatt (2004) points out that although lip service is increasingly being paid to responsible investing through the Statement of Investment Principle and other policy/guidelines, there is little evidence to suggest that mainstream investors have truly integrated this into their core investment process.

Schepers and Sethi (2003) performed a set of extensive interviews with officials at SRI funds and made the following statement:

...the process of stock selection goes along the following lines: typically a committee of staff members of the SRI fund makes investment decisions. Each corporation's social conduct is discussed and a consensus-based decision is made. The research data and background information on the corporation often consists of newspaper stories, anecdotal information, and occasionally conversations with corporate officials. The authors know of no fund that generates detailed, systematic information on various criteria of "socially responsible" conduct.

Figure 3.1, below, pictures how SI decisions are typically being made in an institutional investor organization. The Advisory Committee's responsibilities are to determine the fund's SI criteria and to ensure that those criteria are being implemented by the fund manager. A larger institutional investor organization may have several Advisory Committees. It is then the fund manager's responsibility to make the final investment decisions in accordance with the criteria laid out by the Advisory Committee. The fund manager makes the decision in which stocks to invest based on several sources of information. That kind of information may come from conventional stock analysts placed within or outside the organization. Furthermore, in order to make a final judgement in which companies to invest, the fund manager obtains information from internal or external specialist SRI analysts. Typically, the SRI information origins from external analysts.

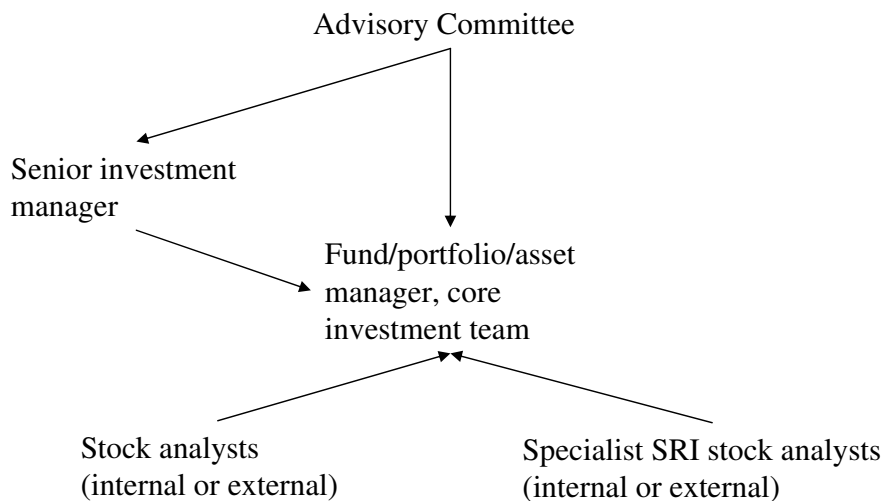


Figure 3.1: Decision making within an institutional investor organization.

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